Date: February 26th, 2018

To

European Commission
DG FISMA – Financial Markets – Capital markets union
Submitted via website

<u>Reference:</u> Public consultation on "building a proportionate regulatory environment to support SME listing"

Dear Sirs,

With reference to the above consultation, we are pleased to hereby submit the views of our association, currently representing 9 ESMA registered credit rating agencies (the short profiles of our Members are attached to this letter).

The consultation document raises a number of proposals in order to build a more proportionate regulatory framework for SME listings. Our response focuses on section II item 5 "credit assessments and ratings for SME bond issuers" as it describes credit ratings as "disproportionately" expensive and proposes that certain market players may be allowed to publish "unsolicited credit ratings". We are highly concerned by this proposal as it corresponds to a fundamental change in the rating market that we believe will lead to reduced investor protection and increase the oligopolistic market structure.

Question 29: Which steps could be taken to facilitate SME bond issuances on SME Growth Markets without incurring high costs for assessing creditworthiness of issuers?

The decision of an SME to issue public debt is often a cultural challenge for an organization operating in the private sphere. Such a decision requires cultural and organization changes to address the required reporting, and leads to a series of costs, such as listing fees, fees for the establishment of the prospectus, fees to lawyers and auditors, fees to arranging banks and potentially fees to rating agencies for the issuance of ratings. Given the overall costs of a public issuance, the costs of ratings are not, in our opinion, disproportionate as described in the consultation paper[1]. It has to be highlighted that credit ratings are not mandatory for debt issuances in the European Union - instead, credit ratings are often recommended as they provide the critical information on an issuer/instrument credit quality to a very large base of potential investors across the EU.

We note that the SME bond market is very different to the market for established large corporations. Large corporations have much higher funding requirements and therefore address global investors to

[1] Instead, we think that SME and MidCap rating agencies charge less than 5 basis points of the issuance volume and make up around 5% of total structuring and placement fees

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ensure a diversified funding base; these large caps tend to use the dominant CRAs to rate their issuances. The case of European SMEs is different as the funding need is far lower and can be covered on the local or, if needed, on the European market. Given their access to local, European investors, European SMEs may well use European CRAs to rate the issuance.

ESMAs report on “Fees charged by CRAs” states that the dominant 3 rating agencies exercise market power and are able to set high fees, thereby achieving operating margins of up to 50%[2]. In addition to these 3 agencies, there are another 23 currently registered and supervised by ESMA. These 23 agencies operate under the same regulatory requirements regarding objectivity, independence and quality of ratings and may equally be used by investors for regulatory purposes. While pricing list of credit rating agencies are not publicly available, assuming that the requirement of the CRA Regulation regarding rating fees (to be cost-based and non-discriminatory) applies, we expect that fees charged by dominant agencies are far higher than those charge by the other agencies. These agencies are competing for rating mandates based on their reputation, track record, methodologies, access to investors but also on pricing. We therefore recommend that potential SME issuers get in touch with European rating agencies with respect to their rating offering[3].

In order to alleviate the “high costs for assessing creditworthiness of issuers”, the European Union could consider introducing grants to issuers covering a share of potential rating fees. Such an approach is currently taken in Singapore to incentivize domestic local currency issuances to be rated[4]

Member States could also consider tax credits to SME issuers with respect to their issuing public debt and all the related costs including rating agencies fees. Alternatively, Member States could consider tax credits to investors specifically investing in the SME Space[5].

Additionally, as a best practice, stock exchanges could recommend SME issuances to be rated systematically – such a wide ratings coverage of SMEs increase investors interests and may

[2] See §21 and chart 1 page 8 of Report dated January 11th, 2018, available at: https://www.esma.europa.eu/sites/default/files/library/esma80-196-954_thematic_report_on_fees_charged_by_cras_and_trs.pdf

[3] Kindly note that CRAs provide a wide range of services. Next to the publicly available rating usable for regulatory purposes by a wide range of investors, CRAs provide also private credit estimates and assessments so that an issuer can familiarize itself with the topic of external credit assessments. Kindly note that CRAs use distinct terminology for their different products.

[4] see press release by Monetary Authority of Singapore dated June 30th, 2017 entitled “encouraging credit ratings in the SGD bond market”). http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/Encouraging-credit-ratings-in-the-SGD-bond-market.aspx.

[5] We would like to cite the example of Italy: With its 2017 Budget Law the Italian government has introduced a new form of tax-incentivized savings, also known as “PIR” (Piani Individuali di Risparmio - Individual mid-term savings plans). They work as *containers* - mutual funds, life insurance policies, assets management - aimed at channeling investments to small and medium Italian companies, therefore supporting the economic development of the country. At least 70% of the PIR’s portfolio has to be invested in instruments issued by Italian or European companies. Of this share, 21% must be invested in small and medium-sized companies not listed on the FTSE Mib. The 2018 Budget Law has, then, expanded their scope with the entry of real estates among issuers, while at the same time introducing a 50% tax credit for consulting services that are preparatory to SMEs listing

contribute to liquidity in secondary market activity. In order to contribute to the right use of ratings, we recommend that each issue should be rated as the (general) issuer rating does not suffice[6]. Given that rating agencies usually publish rating reports providing research information on the issuer, such an approach would be compatible with the requirements of MIFID II and ensure that investors have research available.

The above proposals combine the advantages of the issuer-pays, government pays and trading venues models without the need to create new institutions, as the issuer would remain responsible for the selection of the rating agency out of the ESMA registered rating agencies. Such an approach would create on-going and recurrent demand for SME ratings thereby driving competition in the rating market and result in a more transparent market.

Question 30: What would be the risks associated with a more flexible approach to 'unsolicited credit ratings' by market players other than CRAs and what might be done to mitigate them?

According to the consultation paper, "in the past, investment banks operating in some Member States used to issue 'unsolicited ratings on SMEs'. This practice increased the transparency and visibility of SMEs towards some institutional investors but was not compatible with the CRA regulation, as those investment banks were not registered as CRA. The Commission is seeking views on whether some market players should be allowed to publish "unsolicited credit ratings" on SME Growth Market issuers, provided that those ratings would not be used by institutional investors (such as insurance companies and credit institutions) for regulatory purposes." (hereafter referred to as "the EC Proposal")

We confirm and highlight that the Regulation on credit rating agencies 1060/2009 (as amended) requires that agencies are registered with ESMA before the issuance of ratings. In its "guidelines and recommendations on the scope of the CRA Regulation"[7], ESMA makes clear that the issuance of ratings by other entities is not allowed: "Credit rating agencies established in the EU that are carrying out credit rating activities in the EU without prior registration are operating in breach of Article 2(1) and 14(1) of the CRA Regulation. Any credit rating agency that intends to carry out credit rating activities shall immediately apply for registration by ESMA. Entities must not issue credit ratings until they are registered as CRAs."

Allowing banks to issue public ratings on SME represents a fundamental change to the current framework:

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[6] The issuer rating provides an opinion on the creditworhtiness of the whole entity. The issue rating takes into account structural elements and may lead to higher ratings (in case of eg senior secured debt) or lower ratings (eg in case of subororndination). By way of example, in Russia, the Central Bank of Russia is now implementing reforms in the Russian legal framework focusing on issue ratings.

[7] See (ESMA 2013/720 dated June 17th, 2013; § 10 page 15 available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-720_guidelines_and_rec_on_cra_regulation_scope.pdf

The CRA Regulation imposes a high number of operational and organizational requirements "in order to enhance the integrity, transparency, responsibility, good governance and independence of credit rating activities, contributing to the quality of credit ratings issued in the Union and to the smooth functioning of the internal market, while achieving a high level of consumer and investor protection"[8]. As the EC Proposal sets aside the stringent CRA framework, the EC Proposal results in lower consumer and investor protection.

Also, one of the major concerns of the CRA regulation is the elimination of conflicts of interest. Advisors and investment banks are paid to place the financing with banking or capital market investors. They earn large commissions in the SME space as percentage of financing volume. They have an interest in creating most favorable rating outcomes at this enhances the chance of a successful placement.

Furthermore, having market-players (not registered as CRAs) issuing unsolicited public ratings will add confusion in the market and will weaken investor protection[9]. What would happen in case of conflicting valuations? i.e. the 'market player' unsolicited rating being significantly different from the unsolicited ratings released by the rating agency on the same issuer.

MIFID II, which entered into force in January 2018, requires the unbundling of products and that fees for research reports are disclosed to the clients. The EC Proposal goes against the spirit of the MIFIDII Regulations.

Finally, the EC Proposal will have a substantial impact on the competition in the rating market: SMEs would then either turn to the investment banks directly to provide such "unsolicited credit ratings" or to one of the dominant rating agencies, European rating agencies being squeezed between these two. This proposal would lead to further concentration in the highly oligopolistic rating market.

Question 10 on Key adviser requirements

According to the consultation paper (page 10), "the vast majority of SME-dedicated MTFs across the EU require their issuers to be assisted by a key adviser, i.e. a market professional approved by the exchange. The key adviser plays a prominent role by assessing the company's suitability for the market, bridging the information gap between quoted SMEs and investors".

In our view, such key advisers play an important role in preparing and structuring the offering. Such key adviser assists the issuer in familiarizing with the rules and standards on public markets thereby assisting to the successful placement with investors. We therefore support the best-practice that SME issuers use key advisers – whether this recommendation should be imposed throughout the European Union should best be assessed based on the benefits of a standardized product category against the diversity of the local MTF markets.

[8] See Article 1 of the CRA Regulation.

[9] The period 2001-2003 in Italy where unrated bonds were placed with recommendations from arranging banks is well remembered by retail investors, who were caught in losses of notable defaults occurred in the Italian mid-cap brands.

Key advisers may also assist issuers in the selection of the credit rating agency used for rating the bond issuance. Key advisers and rating agency have a complementary role as advisers may structure an offering while rating agency assign an opinion on the creditworthiness of the issuance usable for regulatory purposes.

We thank you for the opportunity to provide these comments.

Sincerely yours

Thomas Missong — EACRA President

Adolfo Estevez Beneyto — EACRA Secretary General

About EACRA

The European Association of Credit Rating Agencies ("EACRA"), registered in Paris, was established in November 2009. The Members of the Association currently originate from 12 countries and include the following companies:

ESMA registered Credit Rating Agencies

A.M. Best Europe - Rating services Limited (AMBERS) is a subsidiary of A.M. Best Inc who have been providing ratings to the Insurance Sector since 1899. AMBERS' rating coverage includes regional, national and global insurers located throughout Europe, the Middle East and Africa.

Assekurata Assekuranz Rating-Agentur is the first independent German rating agency that has specialized on the quality evaluation of insurance companies

Axesor: The first Spanish Rating agency registered with ESMA. Specialized in the middle market segment, with ample coverage of the Spanish corporate market.

Capital Intelligence (CI) offers independent rating opinions on financial institutions, corporates and governments in a wide range of countries, especially the emerging markets of Asia, Europe and the Middle East.

Cerved Rating Agency is a European Rating Agency providing solicited and unsolicited credit ratings on non-financial companies. The Agency is also recognized by the European Central Bank as a Rating Tool authorized to assess the credit quality of eligible assets used in ECB monetary policy operations.

Creditreform Rating: based in Germany, a company of the Creditreform Group that is European market leader in the sector of business information was founded 2000 and is specialised in ratings of companies, bonds, funds and structured finance products across Europe.

CRIF Ratings: International Credit Rating Agency based in Italy providing both solicited and unsolicited Corporate ratings.

Euler Hermes Rating is a European rating agency located in Hamburg, Germany. We offer credit ratings and research about debt capital market instruments of corporates of all sorts of industries, project finance ratings and credit portfolios. Euler Hermes Rating is a member of Euler Hermes Group and a company of Allianz

Scope Ratings is the leading European credit rating agency, offering clients opinion-driven, forward-looking and non-mechanistic credit risk analysis and contributes to a greater diversity of opinions for institutional investors. Scope Ratings is a credit rating agency registered in accordance with the EU rating regulation and operating in the European Union with External Credit Assessment Institution (ECAI) status. It provides ratings and analysis on Corporates, Financial Institutions, Covered Bonds, Public Finance, Structured Finance and Project Finance.

CRAs registered or recognized according to national legislation outside of the European Union

Fedafin AG : is registered with the Swiss Financial Markets Authority and acts as rating provider to the Swiss stock exchange

JCR Eurasia is an international credit rating institution based in Turkey.

Other EACRA members

Informa is the Marketing, Financial and Business Information leading company in Spain, offering currently more than 3.7 million online scores on Spanish companies